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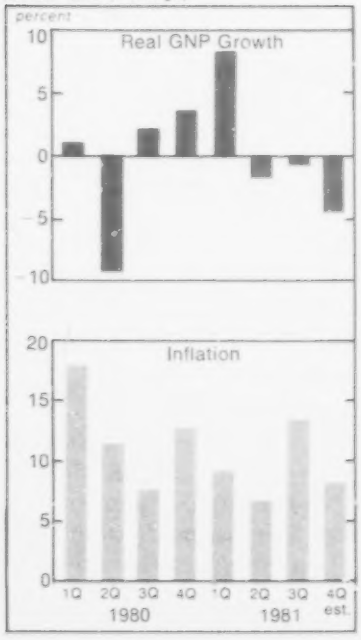
Deep U.S. Decline Unlikely

Until recently, the U.S. economy's decline was slow, erratic, and concentrated in relatively few industries. The weakening, however, is intensifying and now appears more generalized. When industrial production dropped 0.8% in September, almost every major industrial sector—with the important exception of defense production—was down. September also saw a fall of average weekly hours of work in 17 of 20 manufacturing industries. Car sales plunged so dramatically when the late-summer rebate program ended that auto companies had to reinstate them. Housing activity remains depressed, capital goods orders are on a downward trend, and retail sales of non-durables appear to be slackening.

Key U.S. economic indicators

(annual rates of change)



The critical question is whether the current economic weakness will remain relatively mild throughout, or accelerate. This matter may well be settled within the next month or two. The September drop in industrial production and new orders reflects widespread recognition that inventories had become excessive. Beginning steps have thus been taken to correct this condition. If the loss of income associated with production cutbacks leads to further marked reductions in sales, a downward economic spiral could result.

Present indications, however, are that the downward movement will be reasonably restrained. For one thing, the inventory excess does not appear to be either large or widespread. Businesses have been cautious about inventories, owing to the high cost of financing them. And help is on the way on the demand side as well. Interest rates—at least short-term rates—have come down and are expected to fall further. Moreover, federal taxes have been cut, with larger reductions in store for 1982. And further moderation in inflation is likely—the 1982 rate will be about 7%, versus 9% in 1981 and 10% in 1980. All of these influences should support real demand and help restrain the decline in business activity.

Nonetheless, the fourth quarter of 1981 will probably register a drop in real GNP of 4%-5%, at an annual rate. And there may be slight further slippage very early next year. After that, a pick-up is likely, which should accelerate subsequent to the July 1 tax cut. Real GNP could grow by 2% in 1982, fourth quarter to fourth quarter. This would be a welcome change after real growth of well below 1% in 1981 and the fractional decline in 1980.

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Canadian slowdown will not preclude strong economic growth for 1981.

After two quarters of strong growth, business indicators for the third quarter of 1981 point to a slackening of Canada's economy. Housing starts and consumer demand have fallen from their second-quarter highs, exports have declined, and the index of real GDP fell 0.3% in August after a 1.4% decline in July. Although strike activity has contributed to the economic slowdown, reduced aggregate demand has been the major cause. The weaker pace of growth, however, has further eased inflationary pressure—especially in the industrial sector. On balance, Canada's economic weakening will take some steam out of the 4.5% annual growth rate posted for the first half of the year. Nonetheless, real GNP growth of at least 3.5% for 1981 is a strong possibility.

Italy's large current-account gap should narrow in 1982.

Italy recorded a trade deficit of some 14.9 trillion lira in the first nine months of 1981, compared with a deficit of 13.6 trillion lira for the same period last year. While data on this summer's receipts from tourism and other invisibles earnings are not yet available, results to date offer little hope that this year's current-account deficit will be much below last year's $10-billion gap. Nonetheless, the domestic economy is weakening, and the recent realignment of the lira within the European Monetary System has restored most of the competitiveness Italian exports lost over the past year. Both of these factors point to an improvement in the trade balance in volume terms. Stable oil prices in U.S. dollar terms and a somewhat weaker dollar would then leave room for a narrowing in the current-account deficit in 1982. The extent of the deficit decline depends in large measure on the pace of economic recovery elsewhere in Europe, which currently appears likely to remain slow until the second half of next year.

Norway's oil wealth provides leeway for policy maneuvering.

Although successive Norwegian governments have found it difficult to reconcile the fast-growing oil sector with their overall economic strategies, Norway's oil wealth affords it substantial protection against short-term difficulties. Large wage settlements in the oil sector have tended to trigger similarly large settlements in other sectors and to fuel inflation. The current wage agreement permitted a pay rise last spring and allowed for a further autumn adjustment, but oil and gas workers in the Frigg and Ekofisk fields have called illegal strikes to demand an improved system of pay (the Frigg strike has since been settled). Although the strikes are costly, they are hardly a cause for alarm. Norway's trade account for January-September 1981 showed a kr. 10.2 billion surplus, thereby guaranteeing a surplus for the year. Moreover, the recent substantial gas discoveries—at least 100 billion cubic meters proven and with estimates ranging between 200 billion and one trillion meters—from Statoil's first drilling inside the Arctic Circle demonstrate that Norway's energy reserves will last for a century or more.

Australian policy aims to maximize local benefit from resource boom.

In order to increase domestic participation in Australia's resource boom, a broad policy of "Australization" of foreign direct investment is under way. The government recently invited Shell Australia to consider the sale of a 25% interest to local shareholders, and similar advances are expected to be made to other foreign firms. Indeed, the authorities, firmly committed to a long-term Australization policy, seek to promote a 50/50 equity sharing in new resource projects. Other measures taken include the restriction of transfer pricing by multinationals and a 2.5% increase in the sales tax. A direct resources tax has not been imposed, however, nor is one likely in the near future. Nonetheless, the government measures taken so far, combined with efforts by such other sectors as labor to secure a larger role in the resource boom, may affect investment profitability and thus have important implications for foreign investment inflows.

Peru's large public deficit dims economic outlook.

The overriding problem facing the Peruvian authorities is an expanding fiscal deficit. Peru's public-sector deficit reached nearly 6% of GDP last year—up substantially from 1.2% of GDP in 1979—and could widen further to 8%-9% of GDP this year. Spending has grown rapidly on civil servant salaries, defense, interest on debt,

and for certain subsidies. Revenues, on the other hand, have risen slowly, reflecting lower tax collections from traditional exports and an income-tax shortfall that may stem from inadequate tax collection and administration. Peru's large fiscal imbalance raises concerns about the country's inflation and external trade prospects. The rate of inflation has slowed in the past few months—latest data indicate an annualized rate of 43%—but the high level of public spending and deficit financing may keep it from abating further. On the external front, a trade deficit of about $300 million is projected for 1981, versus a surplus of $825 million last year. The trade-balance deterioration is due to a sharp rise in imports demanded by the public and private sectors—spurred by an import liberalization policy—and an export shortfall attributable chiefly to weaker metals prices.

Greece's new government hopes to reduce inflation and spur investment.

The substantial electoral victory by Andreas Papandreou's Socialist Party presages a new direction in Greek economic and foreign policy—the details of which are still uncertain. The new prime minister has promised to bring down Greece's rate of inflation, currently running at some 24%, and to spur productive investment through heavier government involvement in investment decisions. On the external front, the new government intends to reexamine Greece's relations with the European Economic Community, which Greece joined at the beginning of this year, and with NATO. Greece's new government will have to grapple with a wide range of underlying economic problems that include a rate of real wage growth that has far exceeded the rate of productivity growth since 1974. This gap has fueled great inflationary pressures (much of which were bottled up through various price controls) and has reduced private-sector investment, particularly in plant and equipment. A growing deficit in the public sector and an unfavorable shift in terms of trade have added to Greece's difficulties.

Bangladesh's budget and external-payments problems prompt credit and import curbs.

The Bangladesh economy is experiencing serious budget and balance-of-payments problems. Because of a shortfall in commodity aid and the poor performance of public-sector enterprises, bank borrowings for deficit financing were heavy in fiscal 1980-81 (ended June 30). As a result, the IMF suspended drawings from its SDR 800-million Extended Fund Facility. To regain the IMF's favor, the government has sought to reduce the rate of domestic credit expansion, cutting the ceiling on bank lending by 5% for the July-September period. But with attention focused on the upcoming presidential election, little action has been taken to prevent a recurrence of the large budget overrun. Externally, Bangladesh's international reserves fell some $120 million in July-September, despite new short-term commercial borrowing. As of early October, reserves stood at just $130 million, sufficient to cover less than three weeks of imports. The government has taken steps to conserve reserves by restricting import licenses, and these measures, together with the restrictions on credit, should help. However, real economic growth may slow as a result.

Petroleum prices a barometer of Algeria's health.

Price patterns for Algeria's hydrocarbon exports have long been a barometer of Algerian economic health, and recent developments further underscore this rule. Because Algeria has traditionally kept its oil prices at the top of the agreed OPEC band, it has been vulnerable to weakening oil market conditions. Its unwillingness to cut contract prices in line with competing producers, such as Nigeria, has caused oil production to fall from 900,000 barrels per day at the beginning of the year to an estimated 600,000 bpd in August. However, Algeria's recent agreement to trim prices by $2 to $38 a barrel in line with the October OPEC accord at Geneva should restore some competitiveness. Meanwhile, disagreements with customers persist over gas export prices. The long-standing dispute with Gaz de France over LNG continues. And the uncertainty over pricing has spread to exports to Italy through the new Trans-Med natural gas pipeline, delaying the commissioning of the service until a compromise is achieved.

The Constraints on Fiscal Policy

President Reagan's recent observation that the U.S. economy has probably slipped into recession has heightened concerns about the size of the budget deficit in fiscal 1982 and beyond. Because the slump will restrict revenues and trigger expanded transfer payments, some private economists are even saying that this year's deficit could approach or exceed $100 billion—a figure that would virtually preclude a balanced budget in fiscal 1984. Mr. Reagan's proposed $13 billion in added spending cuts and $3 billion in higher revenues would have only a small impact. And the passage of even these limited measures is far from certain.

The administration has been somewhat perplexed about recent developments. Earlier this year, it proposed large tax reductions for both businesses and individuals, to be offset almost dollar-for-dollar by cuts in federal spending. Monetary stringency was to reduce actual inflation and inflation expectations, leading to lower interest rates as investors accepted lower inflation premiums. And higher real growth spurred by the tax cuts was to increase revenues sufficiently to move the budget toward balance in fiscal 1984.

The U.S. Congress initially complied with almost every detail of the proposed tax cuts—although it did scale back the individual reduction and delay its introduction. Congress, however, then attached provisions that had the effect of reducing revenues, such as the "all-savers" certificate, and more generous treatment of investment tax credits and depreciation through leasing activity. Officially, these two provisions were estimated to reduce fiscal 1982 revenues by $5 billion, although it now appears that the revenue loss could be far greater.

Congress then approved only $36 billion of spending reductions from the "current service" levels (what spending would have totaled without legislative action); Mr. Reagan had proposed $49 billion. Moreover, the increased gap caused by Congress' revenue-reducing initiatives was not addressed.

Recent developments have lowered short-term interest rates and bond yields somewhat, but continued investor skepticism has kept interest rates higher than expected, driving up estimated interest costs on the public debt by at least $10 billion. Interest rates stuck in the upper teens also continue to batter the construction industry and reduce consumer confidence. With sales worse than expected, businesses piled up inventories. Production cutbacks to correct this overhang now dim the near-term economic outlook. If real economic growth in 1982 turns out to be only 2%, as against the administration forecast of 5%, the estimated deficit could widen by an additional $25-30 billion.

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data
Algeria	Private-sector participation in economic development to be encouraged.	June	— 4%	29.0*	1,525	Aug.
Angola	South African air attacks and drought aggravate food deficit.	June	— 8%	3.6	500	n. a.
Cameroon	Economy estimated to be growing at 5%-6% real annual rate.	Dec.	— 2%	6.5	790	May
Egypt	Twenty new oil exploration agreements will have been signed by yearend.	Mar.	+ 72%	22.7	535	July
Ethiopia	Coffee farms to be modernized and expanded.	Feb.	— 25%	4.1	125	Aug.
Ghana	Another huge budget deficit and lack of monetary control foreseen for fiscal 1981-82.	June	— 18%	4.6	400	June
Libya	Some nonessential projects in 1981-85 development plan may be delayed.	June	— 8%	23.0	8,050	May
Mauritius	Losses from 20-year-low 1980 sugar output cause investment cutbacks, aggravating unemployment.	Mar.	— 12%	6.5	675	Aug.
Morocco	Poor weather reduces 1980-81 citrus fruit crop yield by 6%.	June	— 10%	18.1	896	July
Nigeria	Investment in new companies to be made easier for local firms with foreign shareholders.	June	— 8%	78.0	1,013	July
Sierra Leone	Depressed agriculture in north to receive $12 million in external grants and loans.	Feb.	— 39%	0.9	262	Aug.
South Africa	Business leaders submit proposals for early implementation of social reforms.	July	— 17%	76.9	2,627	Aug.
Tunisia	The 1982-86 development plan provides for construction of 40,000 new homes per year.	Mar.	+ 18%	8.6	1,350	July
Zaire	No relief in sight from government's fiscal austerity measures.	Dec.	— 5%	6.8	240	Aug.
Kuwait	Several contracts awarded in infrastructure, hydrocarbon development, and small-scale industry.	June	+ 1%	27.3	19,870	Aug.
Qatar	Estimated cost of North West Dome Gas field development project raised 50% to $6 billion.	June	+ 18%	5.0	23,100	Dec.
Saudi Arabia	Official denies government's intention to build $7-billion oil storage facility on Red Sea.	June	+ 23%	117.6	19,500	Aug.
United Arab Emirates	Government threatens tough penalties for foreign firms that violate labor regulations.	June	+ 9%	16.0*	19,275	Aug.

BALANCE OF				
reserves (less gold) in million $	12-month change	months of imports covered	use of I credit, n lions of d
3,586	— 3%	1.3	0
—	—	—	—
86	— 57%	0.7	6
726	— 33%	1.3	108
107	— 17%	1.8	84
148	— 60%	1.5	33
13,378	+ 41%	13.5	0
19	+ 41%	0.3	136
127	— 57%	0.3	448
7,964	— 13%	8.3	0
22	— 30%	0.6	55
920	— 17%	0.5	0
528	— 21%	1.8	0
104	— 42%	1.4	265
3,686†	+ 22%	7.3	0
343†	+ 19%	2.7	0
26,606†	+ 18%	3.4	0
2,633†	+ 31%	8.6	0

Africa

Middle East

*1979

†Excluding state reserves

Virtually all of the key participants in the budget process acknowledge the likelihood of a larger-than-anticipated deficit. But there is a difference of opinion as to how to address it. Some would scale back or delay the individual income tax cuts; others would cut non-defense spending further; still others would limit the increase in defense spending; and many argue that "revenue enhancements" (i.e., tax increases) will be needed.

All of these measures may have to be utilized to some degree if the federal budget is to be held in the $40-50 billion range in fiscal 1982, thus keeping the goal of budget balance in fiscal 1984 in sight. Delaying the personal income tax reductions in 1982 from July 1 to October 1 would save about $7-8 billion in fiscal 1982. The additional 10% reductions in fiscal-1982 non-defense spending Mr. Reagan has already requested, if passed promptly, could save another $13 billion. In an atmosphere of general austerity, the scheduled increase of nearly 20% in the defense budget could perhaps be trimmed back by stretching out spending and scrutinizing costs more closely.

The list of taxes that could be raised is lengthy. Most likely are higher excise taxes on alcohol and tobacco. Adjusting them for inflation and equalizing tax rates on various forms of alcoholic beverages could raise between $5 and $10 billion. Accelerated decontrol of natural gas coupled with a windfall profits tax could raise at least $10 billion in its first year. A 10¢ oil import fee, or an increase in the federal excise tax on gasoline to 14¢ a gallon, would raise about $10 billion. And eliminating deductions for interest on non-automotive consumer credit (consistent with the administration's goal of increasing incentives to save) could raise as much as $4 billion.

The long list of policy actions indicates the magnitude of the measures needed to hold the fiscal 1982 deficit in the $40-billion range. Absent from the list, however, are changes in benefit levels for Social Security recipients, other federal pensioners, and other income transfer recipients. Since these programs together with interest on the debt account for nearly 50% of the budget, exempting this area from budget cuts requires that the axe fall even harder elsewhere.

Of course, the impact of cutting spending further or raising taxes when the economy is contracting will not be beneficial in the short run. The deficit may not shrink as much as expected either. To "chase the deficit" by ever larger spending cuts and ever higher taxes carries the risk of worsening or prolonging the economic downturn. Poorer economic performance will in turn make it less likely that Congress will enact all of these or similar deficit-reducing proposals. So will the fact that 1982 is an election year. But if those who are skeptical about the ability of the United States to put its economic house in order are to be satisfied, Congress and the president must enact enough deficit-narrowing measures, perhaps $30 billion, to demonstrate their control over the budget. Their reward would likely be much lower interest rates in 1982, and the prospect of a durable, less inflationary expansion in 1983 and beyond.

Douglas L. Bendt

PAYMENTS		MONEY AND BANKING							COUNTRIES
MF il- llars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars November 4, 1981	change from year earlier	current monetary conditions	
	Oil output in Jan.-Aug. period down 16% from year-earlier period.	Dec. '79	+ 12%	Dec.	+ 17%	.2335	−12%	Credit to private sector continues to expand.	Algeria
	Oil earnings in 1981 estimated at over $2 billion, owing to higher output.	n. a.	—	—	—	.0325	n. a.	International reserves decline.	Angola
	Oil companies beginning work on new offshore deposits.	Dec.	+ 8%	May	+ 11%	.0036	−23%	Supply of credit very tight.	Cameroon
	External public debt put at $14 billion at end 1980, up $2 billion from '79.	Feb.	+ 12%	June	+ 6%	1.23	−14%	Foreign reserves in July fell $279 million.	Egypt
	Worsening foreign-exchange position brings tighter import license curbs.	June	+ 5%	June	+ 16%	.4925	+ 2%	Use of IMF credit bolsters reserves.	Ethiopia
	Weak export receipts spur improved incentives for commodity exporters.	May	+125%	May	+ 35%	.3700	+ 2%	Credit to public sector up sharply.	Ghana
	Oil output averaged 1.3 million bpd for Jan.-Aug., down 29% from year ago.	n. a.	—	Dec.'79	+ 33%	3.41	+ 1%	Money expansion slows owing to drop in foreign reserves.	Libya
	Rupee devaluation of 20% vs. SDR should boost tourism earnings.	Apr.	+ 15%	July	+ 2%	.1000	−23%	Stringent bank lending restrictions continue.	Mauritius
	Wholesale price of phosphate rock holding steady at $49.50/ton.	Mar.	+ 10%	May	+ 9%	.1850	−24%	Reported foreign-exchange reserves fluctuating sharply.	Morocco
	Tougher import curbs and slower dividend remittances to save reserves.	Sept.'80	+ 9%	Apr.	+ 29%	1.5375	−21%	Tightening of credit availability likely.	Nigeria
	Rising bauxite and rutile exports diversify export base.	Mar.	+ 13%	June	+ 2%	.9925	+ 5%	IMF-imposed tight credit policy continues.	Sierra Leone
	Weakening rand headed toward parity with U.S. dollar.	July	+ 15%	June	+ 40%	1.0440	−22%	Monetary policy to remain tight well into 1982.	South Africa
	Trade gap for first half was $756 million, up 35% from first-half 1980.	May	+ 7%	May	+ 23%	2.0650	−18%	World Bank lends $42 million for grain project.	Tunisia
	Copper prices and world inventories remain low.	May	+ 22%	May	+ 52%	.1875	−47%	Zaire devalued to 5.5 per U.S. dollar in July.	Zaire
	Oil output in Jan.-Aug. averaged 953,000 bpd, down 35% from like period in '80.	Dec.	+ 9%	July	+ 22%	3.5585	− 4%	Money supply expanding steadily.	Kuwait
	Jan.-Aug. oil output averaged 432,000 bpd, down 9% from like '80 period.	n. a.	—	Dec.	− 9%	.2750	0	Credit to private sector expanding steadily	Qatar
	Oil output ceiling of 8.5 million bpd reimposed Nov. 1.	Dec.	+ 2%	Jan.	+ 9%	.2930	− 3%	Money supply growth accelerates.	Saudi Arabia
	Dubai's aluminum export smelter attained capacity production in September.	n. a.	—	June	+ 14%	.2730	0	Sharjah floats a $55-million Euroloan.	United Arab Emirates

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World Interest Rates

market rates of Nov. 4, 1981; bond yields as of Oct. 30, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty large banks 15.00	18.21	15.50	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	14.75 Nov. 5	21.00	15.50	15.00	15.625	11.00	20.125	12.75	7.00	7.4375
Treasury Bills 91-day, Middle Rates	12.16 discount basis	17.65	15.00	15.65	n. a.	n. a.	19.49 87 day	no dealing	no market	5.625 two month
Commercial Paper prime, 3-month, asked	14.00 finance paper discount basis	18.10 finance paper 15% tax w/h	13.80	12.90 Certified	15.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.70	17.80 15% tax w/h	15.00	12.90 Certified	not traded	9.90	24.35	no market	10.625	no market
Government Bonds Long-term, new and old issues, average yield	14.76	16.00	15.60	10.65 20% tax w/h	16.48	10.32	21.06	12.53	6.01	8.40
Industrial Bonds prime, long-term, new and old issues, average yield	15.55 Aa Industrials	18.00	16.85	19.51	17.64	10.55	20.90	13.53	6.875	7.21
Bank Short-Term Rate to Best Borrowers (prime rate)	17.50	20.00	15.50	18.00	17.35	14.50	22.50 ⅛ quarterly fee on outstdng.	14.50	11.50	6.75
Bank Time Deposits 3-month	13.875 Cert. of Dep.	18.10	15.625	15.25	15.50	11.35	10.75	12.75 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	15.25	no market	15.9375	no market	16.75	11.25	no market	13.00	10.75	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8361	1.8745	.02681	.1789	.4512	.000844	.4089	.5577	.0044
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.912 *D*	.5975 *D*	3.779 *D*	1.608 *D*	5.231 *P*	6.751 *D*	2.465 *P*	4.279 *P*	7.916 *P*

Eurodollar Deposits
(London, interbank, bid)
November 5

7-day	14.75
1-month	14.75
3-month	15.125
6-month	15.375

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.036
U.S.-Canada Treasury Bills	−1.602
U.S.-Canada Finance Co. Paper	− .939
Eurodollars-U.K. Local Auth. Deposits	+ .349

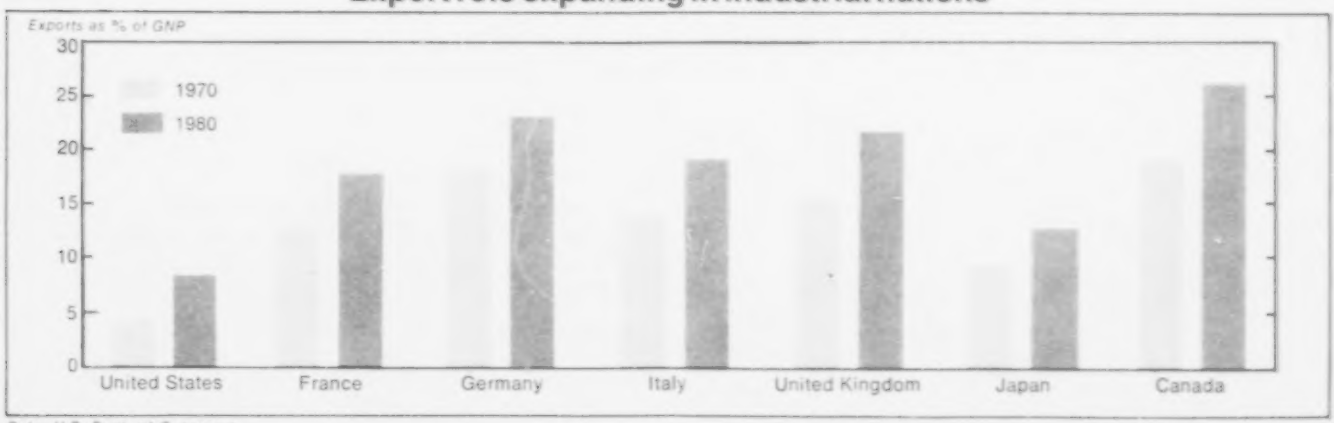
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	16.00
Over 7 yrs.	16.00
DM Bonds	
7 yrs. and under	10.312
Over 7 yrs.	10.187

Gold Price
London afternoon fixing
428.25
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Export role expanding in industrial nations



Data: U.S. Dept. of Commerce

Appraising the European Monetary System

The European Monetary System (EMS), an outgrowth of the old European Community joint currency float or "snake", will celebrate its third anniversary this spring. It was formed in the wake of extreme U.S. dollar weakness in 1977-78 to insulate Europe's financial and trade flows from deviations in U.S. economic policies, particularly as they were transmitted to Europe via dollar depreciation and the inflationary bent of U.S. policy. The desired method of insulation was a unified response that would both underscore and promote European policy harmony.

Now that the EMS has experienced several parity adjustments, an appraisal of its effectiveness seems useful. Any such evaluation should focus on whether 1) intra-European bilateral exchange rates have become more stable; 2) inflationary pressures in Europe have been reduced; and 3) policy harmonization in Europe has advanced. Judged on the basis of these three criteria, the EMS has fallen short of its objectives, succeeding in only one area—stabilizing intra-European bilateral exchange rates. On all other counts, the EMS's success has been less than expected. Indeed, its failings in these other areas may ultimately lead to its demise.

Exchange-rate variance reduced

Almost by definition, a fixed-exchange-rate system assists in reducing bilateral exchange-rate movements between member currencies. In the case of the EMS, deviations from stable parities are the result of two factors: the allowable exchange-rate deviations permitted by the EMS, and official parity adjustments.

The EMS allows bilateral rates to deviate by 2.25% against central parities for all currencies except the Italian lira, which is allowed a 6% deviation band. This amount of bilateral exchange-rate deviation represents an effective reduction in exchange-rate variance between the currencies of the former "snake" members and France and Italy, as compared with the experience of the pre-EMS era. The EMS also enhances the stability of European bilateral exchange rates through the increased substitutability of all EMS currencies for the German mark—despite the mark's worldwide role as an alternative reserve currency. This has tended to ease pressures for changes in bilateral exchange rates, although not entirely.

With regard to official parity changes, there have been two major EMS realignments to date. The first, in the fall of 1979, involved only modest parity modification. The second, in the fall of 1981, instituted an 8.5% change between the values of the German mark and both the French franc and the Italian lira.

Still, even with all the official parity changes and permissable deviations, day-to-day bilateral exchange-rate variations under the EMS have improved. Exchange-rate changes from March 13, 1979 through October 31, 1981 have not been large enough to disrupt European financial or trade flows. Among the EMS members, the largest percentage exchange-rate change during this period was for the mark/lira and mark/franc, and these changes were small given the 20 percentage-point change in the mark/dollar rate that occurred in the same period with a far greater degree of variance.

Official parity changes have been required under the EMS, however. An analysis of the causes of such parity changes—traceable to inflationary pressures and policy actions—is key to understanding the turbulence that underlies the apparent stability within the EMS.

Little impact on inflation front

When the EMS was founded, the two chief additions to the snake arrangement, Italy and France, had inflation rates that differed significantly from such former snake members as Germany (see below). Theory states that in a fixed-exchange-rate system (that is perceived as remaining fixed), where trade and capital-flow barriers are nonexistent, comparable inflation measures will tend toward equality among member countries. The evidence, however, shows that inflation rates have not made much progress toward equality.

Pre- and Post-EMS Inflation Rates

(year-over-year % change in CPI)

Country	March 1979	September 1981
Germany	3.1	6.5
France	10.1	13.9
Italy	13.1	18.3

The reasons for the poor showing on the inflation front are mainly two. First, because the EMS allows for official parity adjustments, the markets do not believe that today's exchange rates will exist well into the future. Hence, business decisions, both financing and pricing policies, reflect the expectation of potential exchange-rate adjustments and varying national policies. Second, there are capital-flow barriers within Europe, particularly with regard to France and Italy, making cross-country arbitrage costly and allowing inflation rates to remain apart or to diverge.

In sum, the establishment of the EMS did little to eliminate the divergence in inflation performances within Europe since it did not allow a textbook fixed-rate system to operate. A true fixed-rate system would have provided the discipline to guarantee effective policy harmony. The failure of inflation rates (and also interest rates) to become more consistent across

Appraising the European Monetary System *(continued from page 7)*

member countries thus also signals the EMS's inability to promote European policy harmony.

Policy harmony not enhanced

The EMS was conceived at a time when intra-European policy differences were overshadowed by differences with the United States. Nonetheless, harmonization in Europe with respect to inflation policies has not existed in the 1970s. Evidence of this is provided by the differences in interest rates that have long persisted among the European currencies. If the EMS countries had made a firm commitment to policy harmony and a fixed-exchange-rate system, interest-rate differentials would have narrowed considerably.

For the EMS to continue to provide stability of bilateral exchange rates within Europe, the need for official parity changes must be reduced. But recent policy shifts indicate that they may increase. Since the first official EMS parity change in October 1979, the United States switched from a relatively inflationary policy stance to an anti-inflationary, tight-money policy. This tended to obscure intra-EMS policy differences, because the exchange-rate consequences of the U.S. policy switch led to a resurgence in the dollar as a reserve currency vehicle. This resurgence came partly at the expense of the German mark. With some of the international pressure off the mark, the EMS enjoyed a period of relative stability.

This relative stability was also characterized by a modest shift in Germany toward policies more consistent with those in France and Italy—evidenced by rising interest rates in Germany. Although this may have been falsely perceived as an indication of German policy tightening, in fact it reflected the markets' moving to equalize interest rates within the EMS as the threat of a German move to a severe anti-inflationary stance lessened. Thus, there was some shift toward policy harmony by Germany in 1980, but it was in the nature of accepting the higher inflation rates of its partners. And indeed, Germany's inflation rate has been rising since the formation of the EMS.

But although Germany's inflation rate is rising, it still is less than double-digit, indicating that the movement toward policy harmony has been small. In fact, that movement begun last year has been overshadowed by events in 1981. Italy failed to adopt policy changes to put itself on a lower inflation path. Thus, even with 6% exchange-rate deviation bands allowed from the official EMS parities and the existence of numerous capital-flow barriers, the pressures for lira depreciation have been building all year. France, after its socialist victory, moved to reverse its previous policies of market deregulation and to act quickly to stimulate its economy, virtually guaranteeing higher inflation. These policy shifts stood in sharp contrast to Germany's growing concern for its rising inflation rate. In view of such large policy differences, the official parity change of the fall of 1981—an 8.5% devaluation of the French franc and Italian lira against the German mark—may be only the first of more to come.

Summing up, the EMS is now at a crossroads. Its success in eliminating much of the bilateral exchange-rate variance within Europe has not been accompanied by moves toward policy harmony and more consistent inflation patterns. The financial markets view this as a problem that is not going away, but getting worse—as evidenced by the continuation of substantial interest-rate differentials. If the EMS is to survive, particularly in a world in which the U.S. dollar's role as an international reserve currency is secure, inflation policies must move in a much more consistent pattern. For Europe to accomplish this will require major compromises among governments, which at this point appear unlikely.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IIQ/80	IIIQ/80	IVQ/80	IQ/81	1979	1980	1981
Gross Size (Claims)	1,206.1	1,248.1	1,321.9	1,346.6	1,110.0	1,321.9	1,550.0
Net Size (Claims)	745.0	775.0	810.0	820.0	665.0	810.0	950.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	280.9	282.0	285.8	289.5	269.5	285.8	335.0
Liabilities to Private Nonbank Foreigners	69.8	72.1	74.7	80.2	65.9	74.7	86.0
Total Claims on Foreigners	347.3	365.0	382.5	390.6	324.0	382.5	440.0
Claims on Foreign Public Borrowers	41.5	46.1	48.8	49.8	42.0	48.8	54.0
Claims on Foreign Private Nonbank Borrowers	129.4	133.1	138.8	142.2	117.7	138.8	165.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.